

## MINNESOTA Department of Revenue

Corporate Tax Division

Mail Station 5100, St. Paul, MN. 55146-5100  
Phone: (612) 282-5747 Fax: (612) 297-4921

June 3, 1997

Mr. Michael Mazerov

Director of Information

Multistate Tax Commission

444 North Capitol Street NW., Suite 425

Washington, DC 20001

Subject: Regulation on the Definition of a Unitary Business

Dear Mr. Mazerov:

The following are some comments regarding the draft regulation on the definition of a unitary business. I have broken down our comments by section as follows:

**I. Application of Regulation. A. Subject of Regulation**

The regulation states that, "The decisions of the United States Supreme Court require all States to determine the scope of a unitary business for purposes of determining **whether specific items of income or loss are properly subject to apportionment** by the taxing State." While this is true, shouldn't this regulation focus on whether related entities are part of the same unitary business, rather than on whether a specific item of income is apportionable. This sentence improperly focuses the scope of the regulation.

**I. Application of Regulation. B. Definitions. 1. "Business Segment."**

The regulation defines the term "business segment" as, "any grouping of business activities, functions, or transactions." The language, "business activities, functions, or transactions" may be interpreted as relating only to line functions and may ignore staff functions. Perhaps the term "business" could be replaced with the words, "operational, administrative or financial."

**I. Application of Regulation. B. Definitions. 2. "Enterprise"**

The definition of "enterprise" contained in the draft regulation states that, "**a single entity** or two or more entities under common ownership or **control** with respect to which [this State's income/franchise tax] requires a determination of the unitary businesses being conducted within this State."

The reference to single entity should be eliminated to focus the regulation on the unitary relationship between the entities. Also, the word "control" should be struck from this definition because control, in itself, is a unitary attribute.

**I. Application of Regulation. B. Definitions. 5. "Single Entity"**

The term "single entity" is used on a number of occasions in the regulation. Should this term be defined?

Mr. Michael Mazerov

Page 2

June 3, 1997

## **II. Existence of Trade or Business. A. Unitary Business Concept.**

The last sentence of this paragraph states that,

"Where an enterprise consists of more than one business segment, it is necessary to determine whether the different business segments constitute a single unitary business, or whether the enterprise has more than one unitary business."

The words the words "business segments" should be replaced with the term "business entity(ies)."

## **II. Existence of Trade or Business. A. Diverse Lines of Business.**

It is suggested that the words "business segment" be replaced with the words "business entity."

The last sentence of this paragraph states that,

"However, diversification of the enterprise's portfolio and reducing the risks inherent in being tied to one industry's business cycle through the making of investments does not by itself establish that the segments of an enterprise constitute a unitary business."

Diversification between two business segments may result in mutual dependency, and therefore such diversification may be evidence of a unitary business. This is one possible unitary attribute that should be weighed in context with all the facts in the case. As such, it is redundant to state that, diversification by itself does not establish that the segments of an enterprise constitute a unitary business. As a result, it is recommended that this sentence be struck.

## **II. Existence of Trade or Business. A. Commonly Owned or Controlled Business Entities.**

It is recommended that the words "a single formula" be replaced with the words "the statutory formula."

## **II. Existence of Trade or Business. D. Separate Trades or Businesses Conducted within a Single Entity.**

It is proposed that this entire paragraph be stricken because the question of whether a particular item of income is apportionable to a state should be addressed in the regulation related to the definition of non-business income. Also, it is recommended that the words, "An enterprise structured as" be struck and that the first sentence of this paragraph begin with the words, "A single entity...."

## **III. Determination of a Unitary Business. A. General Considerations.**

This paragraph states that, if a business segment of an enterprise is sufficiently related to one or more of the enterprise's other business segments to constitute a single unitary business, then that portion of the business income...attributable to the taxing state is determined by formula apportionment.... For states like Minnesota that employ domestic combination reporting (or

Mr. Michael Mazerov

Page 3

June 3, 1997

some form of "water's edge" reporting), the combined group is limited to only domestic corporations, even though the unitary business may include foreign subsidiaries. Some amending language that clarifies that the combined group is limited to domestic corporations is recommended.

**II. Determination of a Unitary Business. B. Unitary Business Unaffected by Formal Business Organization**

This section was redundant given prior language contained in Part II, Section C. and D. Perhaps this paragraph could be deleted.

**II. Determination of a Unitary Business. C. Description of Tests Used to Determine Scope of Unitary Business.**

The third sentence of this section states that,

"Evaluation of the objective characteristics of an investment's use and the investment's relation to the enterprise and the business being conducted by the enterprise within the taxing State will indicate whether there is a mere flow of funds arising out of a passive investment.

This paragraph is more suited to the regulation on the definition of business/non-business income. However, if this paragraph is retained, it is recommended that the word "investment(s)" be changed to "capital transaction." In Allied Signal, Inc. v. Director, Div. of Taxation, 112 S.Ct. 2251, 2264 (1992) the United States Supreme Court noted, "the important distinction between a capital transaction which serves an investment function and one which serves an operational function." What was being measured in this case was the "capital outlay" not an investment. The term "investment" was a characterization of the capital outlay. Therefore, use of the term "investment" in this section of the regulation is ill-suited.

The next paragraph states that,

Satisfaction of any of the following three alternative tests establishes the **presence** of a unitary business, subject to the additional requirement of unity of **control** .... (Emphasis added.)

It is recommended that the word "presence" be replaced with the word "existence." Also recommended is the replacement of the word "control" with the word "ownership."

**II. Determination of a Unitary Business. C. Description of Tests Used to Determine Scope of Unitary Business. 2. Three Unities Test.**

This paragraph contains language which states that, "...unity of operation as evidenced by central purchasing, advertising, accounting and management divisions, and a unity of use of the centralized executive force and general system of operation....

Mr. Michael Mazerov

Page 4

June 3, 1997

It is recommended that the "and" between "accounting" and "management" be replaced with a comma and the word "or". Also we would recommend that the word "and" situated between the words "executive force" and the words "general system of operation" be replaced with the word "or."

**II. Determination of a Unitary Business. C. Description of Tests Used to Determine Scope of Unitary Business. 3. Mobil Factors Test.**

The regulation states, "See Reg. \*\*\* for special rules that govern the determination of whether a pure or passive holding company constitutes a part of a unitary business with one or more affiliates conducting active business operations." The term "pure or passive holding company" is not a defined term and it should probably be defined.

**II. Determination of a Unitary Business. D. Analysis of the Three Alternative Tests of a Unitary Business. 3. Mobil Factors Test Overall Test.**

A sentence in this paragraph states that, "The determination of whether a unitary business exists is made on the basis of an overall evaluation and there is no prescribed level of each of the factors that must be present in each case." It is recommended that the words, "of the facts" should be inserted after the words "overall evaluation." There is a question as to whether the writer is referring to an overall evaluation of the facts in the case as they apply to the three factors test, or whether the words "overall evaluation" apply to the factors themselves.

**II. Determination of a Unitary Business. D. Analysis of the Three Alternative Tests of a Unitary Business. 4. Classification of Particular Business Operations.**

It is suggested that the first sentence of this paragraph be changed as follows:

Under the Mobil factors test, a particular ~~fact/business operation~~ may be classified as ~~suggestive of~~ one or more of the factors. In these circumstances, it is unimportant whether the particular ~~fact business operation~~ is unambiguously classified as either functional integration, or centralization of management, or economies of scale.

The following is an alternative suggestion:

Under the Mobil factors test, a particular operational, administrative or financial activity, function, or transaction may evidence ~~business operation may be suggestive of~~ one or more of the factors. In these circumstances, it is unimportant whether the particular activity, function, or transaction ~~business operation~~ is unambiguously classified as either functional integration, or centralization of management, or economies of scale.

Also, the second sentence of this paragraph, as shown below, needs to additional clarification.

The absence of a particular business operation from the list set forth under a specific analytical factor in the subsequent part of this regulation does not

Mr. Michael Mazzerov

Page 5

June 3, 1997

indicate that integration of the missing business operation among the business segments being analyzed is insignificant or irrelevant to determining the presence of the factor.

**II. Determination of a Unitary Business. D. Analysis of the Three Alternative Tests of a Unitary Business. 5. Illustration of Mobil Factors Test. a. Functional integration.**

The word "significantly" should be struck from the first sentence and the word "business" should precede the word "segments."

**II. Determination of a Unitary Business. D. Analysis of the Three Alternative Tests of a Unitary Business. 5. Illustration of Mobil Factors Test. a. Functional integration. i. Sales, Exchanges, or Transfers of Products.**

In the first sentence, the word "indicate" should be replaced with the words "is an indication."

**II. Determination of a Unitary Business. D. Analysis of the Three Alternative Tests of a Unitary Business. 5. Illustration of Mobil Factors Test. a. Functional integration. ii. Common Marketing.**

It is suggested that the following changes be made to the first sentence:

The sharing of common marketing features among business segments is an indication of functional integration ~~when such marketing results in significant mutual advantage.~~

Since a unitary determination is based upon the preponderance of all the evidence in the case, the word "substantial" should be struck from the second sentence, because this adjective suggested that, unless there is a substantial portion of common marketing, no consideration should be given to any such activity. Even if there is a minimal level of common marketing, that fact is considered in making the unitary determination but is given lessor weight in the determination.

In the third sentence, the words, "or controlled in-house advertising office" should be struck because an in-house advertising department is a classic example of "functional integration" of a kind which may achieve substantial economies of scale.

It should be noted that there is no reference to a common sales force or sales strategy. Significant economies of scale can be achieved through integrating sales forces among corporations. One of the significant advantages of some of the acquisitions we have seen (for example, the pharmaceutical industry) is the integration of the sale forces between the two operations. Significant economies of scale can be achieved through the integration of sales forces.

Mr. Michael Mazerov

Page 6

June 3, 1997

**II. Determination of a Unitary Business. D. Analysis of the Three Alternative Tests of a Unitary Business. 5. Illustration of Mobil Factors Test. a. Functional integration. iii. Transfer or Pooling of Technical Information or Intellectual Property.**

The words, "when the matter transferred is significant to the business segments' operations" should be struck because all of the evidence should be weighed in a unitary case, and the significance of each piece of evidence should be considered in context with other unitary attributes.

**II. Determination of a Unitary Business. D. Analysis of the Three Alternative Tests of a Unitary Business. 5. Illustration of Mobil Factors Test. a. Functional integration. iv. Common Distribution System.**

The word "indicates" should be replaced with the words, "is an indication of."

**II. Determination of a Unitary Business. D. Analysis of the Three Alternative Tests of a Unitary Business. 5. Illustration of Mobil Factors Test. a. Functional integration. v. Common Purchasing.**

The following changes should be made to this paragraph:

Common purchasing of ~~substantial quantities of~~ products, services, or intangibles from the same source by the business segments, where the purchasing results in ~~significant~~ cost savings or where the products, services or intangibles are not readily available from other sources is an indication of and ~~are significant to each segment's operations or sales, indicates~~ functional integration.

**II. Determination of a Unitary Business. D. Analysis of the Three Alternative Tests of a Unitary Business. 5. Illustration of Mobil Factors Test. a. Functional integration. v. Common or Intercompany Financing.**

The following changes should be made to this paragraph:

~~Significant~~ common or intercompany financing, including the guarantee by, or the pledging of the credit of, one or more business segments for the benefit of another business segment or segments indicates functional integration, ~~if the financing activity serves an operational purpose of both borrower and lender.~~ Lending which serves an investment purpose of the lender does not necessarily indicate functional integration. (See III.D.5.b., below, for discussion of centralization of management.)

**II. Determination of a Unitary Business. D. Analysis of the Three Alternative Tests of a Unitary Business. 5. Illustration of Mobil Factors Test. a. Centralization of Management. i. Facts Indicating Centralization of Management.**

The word "integrate" should be replaced by the word "control" in the first sentence. Also, the words "those operations" should be replaced by the words "their operations."

Mr. Michael Mazerov

Page 7

June 3, 1997

The indicated changes should be made to the following sentences:

"Centralization of management is indicated when management operates to control ~~ensure that~~ the business segments."

"Existence of common officers and/or directors, ~~may while relevant to a showing the existence of centralization of management, does not alone indicate centralization of management. Common officers are more likely to indicate centralization of management than are common directors.~~"

**II. Determination of a Unitary Business. D. Analysis of the Three Alternative Tests of a Unitary Business. 5. Illustration of Mobil Factors Test. a. Centralization of Management. ii. Stewardship Responsibilities Distinguished.**

The entire section regarding stewardship responsibilities should be eliminated since the United States Supreme Court has not used this term in determining the existence or lack of existence of a unitary business.

If you have any questions regarding these comments, please feel free to call me at (612) 282-5747.

Very Truly Yours,

William J. Lunka,  
Corporate Technical Manager